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Impact of takeovers on profitability of target companies: Evidence from Croatian companies

Josipa Višić

University of Split, Faculty of Economics, Croatia

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ABSTRACT

It is possible to find scientific confirmation of positive, negative or neutral influence of takeovers on company's profitability. Therefore, this study aimed to highlight the sensitivity of research results on manipulation in terms of used methodology and indicators. Using *t*-test for paired samples and five selected profitability indicators for target and peer companies, it has been proven that it is possible to obtain significantly different results even when using the same sample and the same reference period. The research has been performed on the sample of Croatian companies, which were taken over in the period from year 2003–2008.

1. Introduction

Takeovers have been studied for decades, yet globalization, deregulation and intensifying competitive pressures make this external form of growth still an interesting subject of research. Volatile business environment forces companies to quickly adapt to new conditions. Therefore, external growth, despite its significant cost and accompanying risk, becomes increasingly important.

Numerous theoretical and empirical studies are dealing with different aspects of takeovers, such as reasons why companies decide to engage in takeovers, success factors of these processes, their effects, and others. The focus of this research is the effect of takeover on the company's performance, or more precisely its profitability.[1] Almost proportionally, numerous research studies indicate both negative and positive effects. However, empirical research in the field of finance mainly indicates positive effects, while theoretical studies, often from the field of industrial organization, are more skeptical toward possible positive effects (Tichy, 2001). The question is why the number of takeovers, as well as their value, grows at global level, gradually including even less developed countries, if numerous empirical studies suggest that a takeover will most likely have a negative impact on company's performance, that is, on its profitability.

The analysis of various empirical studies on the effects of takeovers concluded that possible reasons for conflicting results of the above mentioned studies are the following: a) different opinion of researchers what is regarded as a successfully completed takeover process, b) numerous stakeholders, c) various analyzed data, and d) selected time span for data analysis. When analyzing the impact of takeover it is necessary to define what a successful takeover process is, namely, can a venture be considered successful when it provides a return of; for example, ten percent if the same funds invested elsewhere would achieve a higher return? Furthermore, a takeover process has an impact on a large number of involved stakeholders varying

[1] Company's performance in the narrow sense refers to profitability, while in the broad sense refers to other financial and non-financial indicators of business success as well.

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from company's shareholders, employees, suppliers, competitors, and even to the whole society. That is the reason why takeovers can at the same time cause positive effects for shareholders of target companies and distort competition rules of a home country. Hence, even if one accepts a particular opinion on what is regarded as a successfully completed takeover process, the question still remains for which interested party is this process beneficial. Further, McDougall's research (1995)[2] on Canadian companies showed that companies were willing to accept short-term decline in the level of profitability if they could achieve a long-term goal of improved performance. With all of the above stated, it is also necessary to mention the different theoretical approaches while exploring takeovers. Larsson and Finkelstein (1999) classified them into the following research standpoints: a) strategic management, b) economics, c) finance, d) company's organization, and e) human resources.

Research presented in this study is distinctive because it is focused solely on the profitability of target companies. Namely, this study focuses solely on the target companies which continue to operate independently after the takeover and not on newly created companies. Furthermore, by using several different indicators of profitability and research methods, the study will prove that research results can be directed towards desired objective by varying the used parameters and the research methodology. This represents a significant scholarly contribution because the research performed on the same sample at the same reference period using different parameters, provided different conclusions about the impact of takeover on profitability of target companies. Additionally, this research used stricter criteria for forming the control group of companies.

The research was performed on the sample of Croatian target companies. In developed countries takeovers have been the subject of numerous scientific and professional studies for decades. Most of these studies refer to American companies, while in developed European countries number of similar studies grows along with the growth of the number and value of takeovers including European companies. In Central and Eastern Europe, including Croatia, takeovers are rather rarely studied, partly due to the gradual inclusion of their companies in these processes, and partly due to problems related to scarce databases. Croatian companies are part of the world market which becomes increasingly interesting for investors and therefore, it is assumed that the number and value of inward[3] investment in form of takeovers will increase. Welcoming such investments should be done with certain dose of reserve because many empirical studies point out a significant proportion of unsuccessful takeovers, that is, takeovers with a negative effect on company's performance. However, it is important to emphasize that conclusions about the impact of takeovers on profitability are not limited to Croatian territory, and it could be applied to any other country sample.

The paper proceeds as follows: Section 2 describes data and estimation procedure and presents the main results of the study. The conclusion is presented in Section 3. Overview of the relevant literature is not presented as a separate section for two reasons. First, detailed literature overview of research on the impact of takeovers on profitability would be a separate paper in itself due to its volume, and second, significant studies and authors are mentioned while discussing the results of this study.

2. Data description, estimation procedure and results

2.1. Data description

The research included companies that were involved in the process of takeover. This study made no distinction between mergers and acquisitions which is in accordance with the approach adopted by many authors.[4] Further, the analysis does not include acquirers and focuses only on the target companies, meaning joint stock companies registered in Croatia. Acquirers are both domestic and foreign companies and individuals and, therefore, due to limitations in the availability and comparability of data, the analysis has focused on the target companies that continued to operate after the takeover. Due to differences in classification of expenses in the income statement, companies dealing with financial and insurance activities were not included in the sample despite a significant proportion of their takeover value. Taking into account that many empirical studies on the impact of takeover on company's profitability do not sort sample according to company's industry, the sample was not divided according to company's main activity. Consequently, the obtained conclusions are applicable to all industries.

The research methodology required the availability of target company's financial information for a year before and three years after the takeover; therefore the analysis included takeovers performed in the period from 2003 to 2008.[5] There were 366 takeovers in the period from 1998 to 2008 which included Croatian joint stock companies. Pattern of their number and value throughout this period is shown in Fig. 1. These values are relatively small compared with the same data for developed European countries, yet it is interesting to notice that their pattern corresponds to the rhythm of the takeovers observed on the worldwide level. Several authors (Tichy, 2001; Scherer, 2006), have emphasized the cyclical movement of takeovers, i.e. waves of takeovers which are present in Croatian takeovers as well.

[2] It should be noted that in this study foreign owners proved to have a better influence on the company.

[3] Economic development and country specific factors are expected to make Croatian companies more attractive as target companies.

[4] Due to a similar approach to the issue of impact of takeovers on company's profitability, the following two papers are emphasized: a) Gugler et al. (2003) and b) Kamerbeek (2009). Further, takeovers are processes used to buy a part or the whole company, and, in accordance with the relevant scientific theory and the OECD's definition, this term is used as a superior term to the concepts of merger and acquisition.

[5] Year 1998 is a significant year when analyzing Croatian takeover processes, since privatisation process then reached the phase that involved privatisation of majority of Croatian banks. In the period from 1998 to 2001, there were 153 takeovers which included Croatian target companies. However, due to the changes that occurred in the format of financial statements and in order to maintain comparability of data, the sample did not cover takeovers in the period before the year 2002.